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Some Top Banks See Big Profits In Junk Bonds

By DAVID NEUSTADT

NEW YORK — Call them contrarians, but officials at First Chicago Corp. think the depressed junk-bond market actually offers great profit opportunities.

This week, the big Midwest bank announced it had hired a Wall Street veteran to lead trading and dealing in the high-yield securities market. First Chicago said it believes it can limit its risk and position itself for better times in the devastated market.

"A market that is disorderly, with people leaving and people coming, is a decent market for traders, if you are savvy," said Geoffrey L. Stringer, corporate senior vice president. "We will have limited exposure. To trade, you don't have to take a large position or hold big inventories."

ANALYSIS: *Follow-up on the news*

Owen J. Cheevers – a former managing director at the Merrill Lynch Pierce Fenner & Smith brokerage unit of Merrill Lynch & Co. – was hired Monday to be managing director in charge of developing First Chicago's strategy for entering the high-yield business.

Others Pounce, Too

First Chicago is just the latest of several commercial banks to see opportunities in the junk market. Bankers Trust New York Corp., J.P. Morgan & Co. and Citicorp already have high-yield units that are trading bonds. Almost all hope to underwrite new issues when the market recovers.

Other banks see junk, especially at its currently depressed prices, as a good investment.

"The long-term competitive dynamics are in our favor," one banker argued. Several of the big investment banks are responsible for deals that have gone bad. "That creates some ready acceptance for someone else to do new, high quality business," he said.

Regulator Sees Positives

At least one regulator said he thinks banks could make a positive contribution to the market. "Banks could bring some stability to the market, in part because of their exposure to securitization," said an official at the Office of the Comptroller of the Currency. "They could bring newer structures and some credit enhancement."

Banks lend to the same kinds of companies that tap the junk bond market, the official said.

Wall Street investment bank-

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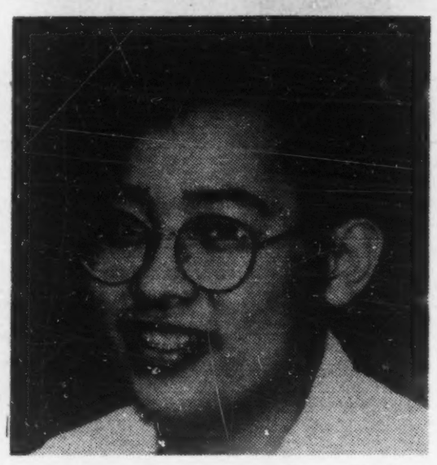
INSIDE NEWS

MANAGEMENT



Peggy Turbett

FRANCIS RAMOS will join 600 other high school students at a conference of the Academy of Finance on Friday. Excerpts from his award-winning essay on a need for reform of the financial services industry appear today.
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CONSUMER

CROSSLAND SAVINGS is the first bank in the competitive New York market to include a buyer-protection plan with its personal checking accounts.
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FINANCE

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NCNB TEXAS National Bank is installing the latest generation of high-speed image processing technology from TRW Financial Systems in its lockbox operation.
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COMMENT

COLLATERALIZED mortgage obligations may be just the ticket for banks seeking to boost profits through their investment portfolios, writes Jonathan Leader. *Page 4*

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Disputes Stall Fraud Trials, Panel Told

By AMY SUZANNE KING

WASHINGTON — Conflicts between federal criminal investigators and lawyers seeking to recover failed thrifts' assets are delaying prosecutions of fraud at those institutions, a U.S. attorney said Wednesday in congressional testimony.

The disputes – involving Justice Department officials and attorneys working for the Federal Deposit Insurance Corp. and the Resolution Trust Corp. – are slowing disclosures of documents that law enforcement officials need to bring criminal charges, Jerome Arnold, the U.S. attorney for Minnesota, told a House Government Operations subcommittee.

Efforts to obtain documentation and records of conversations needed in criminal prosecutions have consumed an inordinate amount of time and money because the FDIC and RTC lawyers are reluctant to part with the information.

Fear on Asset Restitution

The lawyers, often independent attorneys under contract to those agencies, invoke attorney-client privilege to withhold documents out of fear that they will

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House Members Cite Concerns on Bailout

By ROBERT M. GARSSON

WASHINGTON — Even though the passage of a new savings and loan bill is not expected this year, legislators and regulators began laying the groundwork for such a measure Wednesday.

Members of a House Banking subcommittee raised concerns about the slow pace of dealing with insolvent institutions, the impact of new lending rules on home construction, and public disputes between different agencies over how to proceed on the bailout.

Attacking Golden Parachutes

Meanwhile, bills were introduced that would abolish the Office of Thrift Supervision and give the Federal Deposit Insurance Corp. the authority to block executives of failed thrifts from receiving lavish severance packages.

The concerns raised are likely to form the basis for legislation that would amend last year's massive thrift bailout. Such a bill is widely expected, but considered unlikely this year because of opposition by members of the Senate Banking Committee.

Some of the developments on Capitol Hill suggested that the next bill could spell the end of an independent thrift industry.

Rethinking the Ballout
Bills before Congress would:

- ☑ Abolish the Office of Thrift Supervision.
- ☑ Abolish the Resolution Trust Corp. Oversight Board.
- ☑ Authorize the FDIC to cancel lavish severance packages for executives of failed institutions.
- ☑ Prohibit insured institutions from selling at branches debt issued by affiliates.

For example, Rep. Jim Leach, R-Iowa, won support from state and federal regulators for a bill he introduced late Tuesday afternoon that would abolish the Office of Thrift Supervision and transfer its duties to the three federal banking agencies.

Support Is Broad

Mr. Leach said the supporting comments, from the Federal Deposit Insurance Corp., the Conference of State Bank Supervisors and the American Council of State Savings Supervisors, should give his proposal a boost next year.

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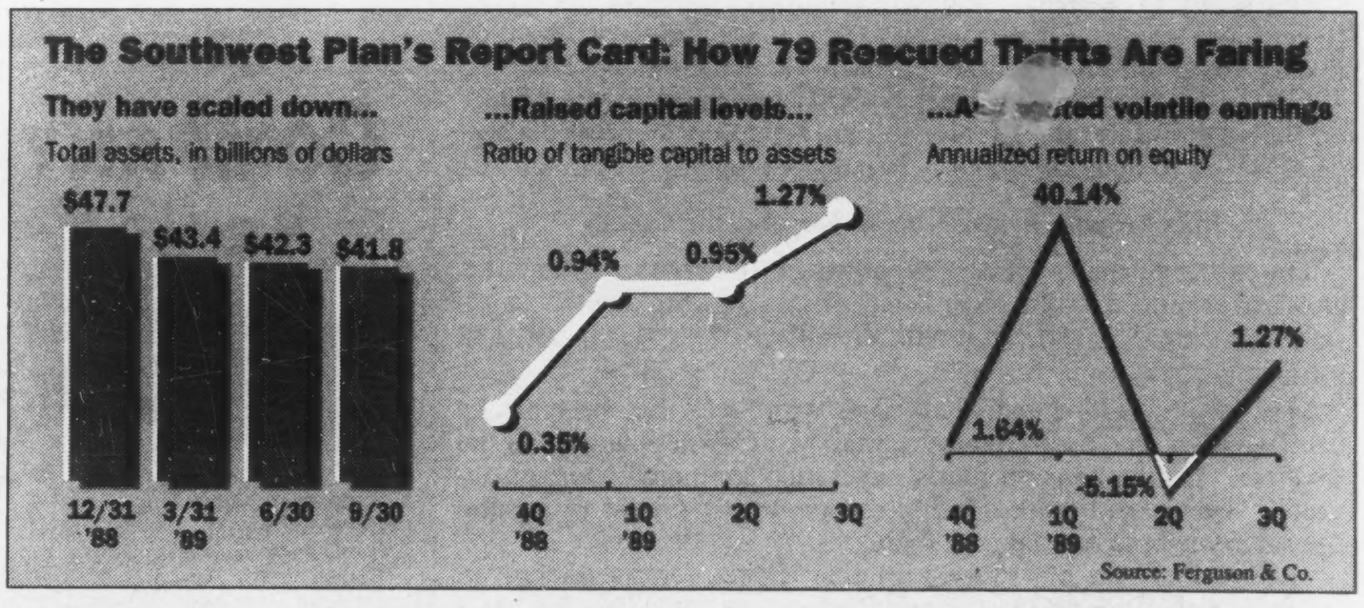

Profits in Texas S&L Deals Only Average

By STEVE KLINKERMAN

DALLAS — Maybe M. Danny Wall didn't give away the store after all.

Despite widespread criticism of the regulator's fire sale of insolvent Texas thrifts in 1988, a review of the deals indicates that the government is better off for having done them.

While two of the 15 deals have produced extraordinary returns for investors so far, the majority are yielding only reasonable profits. In fact, it appears that most acquirers are getting too small a return for the risks they incurred.

And, by stemming the losses at the failed thrifts nine months before the bailout law was passed, the government curbed its losses and helped stabilize the Southwest financial industry. Equally important, experts said, assets were moved from government ownership into private hands.

To be sure, the deals engineered by Mr. Wall are still open to criticism. And part of the reason why the transactions are looking better from the government's point of view is that key elements have since been changed. But results for the first nine months of 1989 show that the so-called Southwest plan was far from the across-the-board giveaway that it has been portrayed as.

Criticism over the government's plan for dealing with failed savings associations in the Southwest – under which 79 insolvent thrifts were merged into 15 institutions and sold to investors – is among the factors that prompted Mr. Wall to resign as the nation's top thrift regulator.

Mr. Wall pushed through the rescues while pre-

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COMMENT / *By Jonathan Leader*

CMOs Offer Big Rewards For Small Portfolio Risk

With loan demand declining, banks and thrifts are focusing more attention on their investment portfolios to earn profits.

But what to do? The yield curve is flat, and interest rates are at the low end of their five-year range. In this environment, how can a financial institution generate a healthy spread over its cost of funds without incurring a lot of risk?

Fortunately, there just may be a free lunch.

Yields Exceed Treasuries'

Derivative mortgage securities, known as collateralized mortgage obligations, offer yields well in excess of Treasuries, extremely high credit quality, and low price volatility. In many cases, CMOs can be used to generate yields of 75 to 125 basis points more than those of Treasury securities.

CMOs are big business. More than $330 billion worth are outstanding, and new issues arrive at a rate of more than $10 billion a month.

More than 90% of CMOs are collateralized by mortgages guaranteed by the Government National Mortgage Association, Federal National Mortgage Association, or Federal Home Loan Mortgage Corp. More than 70% of CMOs are bought by financial institutions, and most are in the second-lowest risk-adjusted capital category (20%) for banks and thrifts.

What is a CMO? It's a multiclass bond issue collateralized by fixed-rate mortgage pass-through securities. The cash flows of the underlying mortgages are used to make principal and interest payments.

Difference in Payments

The key difference between a Ginnie Mae pass-through and a CMO is in the distribution of principal payments. With a conventional pass-through, the interest and principal payments received each month from mortgage holders are passed through to all security holders on a pro rata basis.

The CMO structure substitutes sequential retirement of bonds for the pro rata return of principal found in the pass-through. Thus, mortgage-backed securities carry short-, intermediate-, and long-term maturities.

Typically, the first class of CMO bonds gets all principal generated by the issue until it is retired, then the second class begins to receive principal, and so on.

CMOs have opened the mortgage markets to many investors who might otherwise be excluded by the longer maturities of standard pass-through securities. The typical CMO structure does not eliminate the prepayment uncertainty that has long been associated with mortgage collateral. CMOs do, however, offer a degree of prepayment protection not found in regular pass-throughs.

'CMOs can be used to generate yields of 75 to 125 basis points more than those of Treasury securities.'

Like other mortgage securities, CMOs are priced to yield a spread over Treasury securities of comparable maturity, that is, over a Treasury security with a maturity approximating the CMO bond's average life.

Asset-Liability Matching

Recent innovations in the structure of CMOs have led to the creation of classes especially attractive for financial institutions that are concerned with matching assets against liabilities.

In particular, floating-rate CMOs have coupons that reset either monthly or quarterly according to a formula based on the London interbank offered rate. A typical floater, for example, may have a coupon that resets at a spread of Libor plus 70 basis points. Because Libor averages about 100 basis points higher than Treasury bills, floating-rate CMOs, in turn, have coupons about 170 basis points higher than these bills.

The monthly reset feature of floating-rate CMOs leads to very limited price risk, and the income flow from the securities moves in the same direction as short-term interest rates.

Variable-Rate CMOs

Floating-rate CMOs are a highly attractive variable-rate asset, making them an excellent match against variable-rate liabilities. As such, they offer a positive spread over a financial institution's cost of funds in both rising and falling interest rate environments. Floating-rate CMOs are eligible investments for all financial institutions.

Another category of CMO highly attractive for financial institutions is the PAC bond. These are fixed-coupon CMOs designed to maintain their average life regardless of interest rate movements.

For example, a typical two-year-average-life PAC bond will maintain its average life even if

See **CMO** *page* **20**

Mr. Leader is president of Liberty Capital Management.

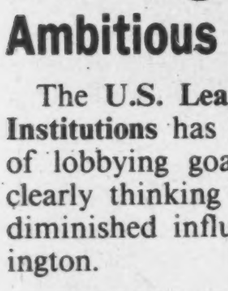
THE LOBBYISTS / *By Barbara A. Rehm*

U.S. League Sets Ambitious Agenda

The **U.S. League of Savings Institutions** has an 18-item list of lobbying goals for 1990 – clearly thinking big despite its diminished influence in Washington.

The league's top officials compiled the list early this month and picked four items as priorities. But the underlying objective is to make a thrift charter a more attractive investment. Mr. Levy figures the more capital that thrifts can attract, the less Uncle Sam will have to spend on bailing out the industry.

"We carry the baggage of a huge problem and a huge bill that was presented to the American people," acknowledges **Gerald J. Levy**, chairman of the league's Federal Affairs Policy Committee and chairman of **Guaranty Bank for Savings,** Milwaukee. "But tarnished image or not, what we are trying to do here is reduce the total cost [of the bailout]."



Gerald Levy

The league's top priority is accelerating the equalization of deposit insurance premiums paid to the government by banks and thrifts. Under the thrift-bailout law, banks and thrifts ultimately will pay 15 cents for every $100 in deposits. However, until that parity arrives in 1998, S&Ls will pay more than banks. Next year, thrifts will pay 23 cents to the banks' 15 cents.

"With thrift powers more constrained than banks' and regulation at least as stringent as banks', why would anyone invest in a [thrift] when it has to pay more for deposit insurance than a commercial bank?" asks the league's lobbying material.

Easing the qualified thrift lender test is another target. The association says the July 1991 requirement that thrifts keep 70% of their assets in home finance will lead to an unhealthy concentration of thrift assets.

The league is also lobbying to ensure that the $13 billion thrifts have locked up in the Federal Home Loan Bank System is not spent for any more of the bailout. The Home Loan banks are already contributing $300 million a year, and there is talk of tapping the system to supply working capital for the **Resolution Trust Corp.**

Other priorities of the league are defeating an expected rule from the Office of Thrift Supervision that would restrict dividend payments by thrifts, fighting a merger of bank and thrift regulatory agencies, and allowing a thrift to lend more of its capital to one borrower. The lending cap is now 15% of capital.

Mr. Levy concedes that Congress is not likely to pass a thrift bill this year because lawmakers are burned out on the topic and would just as soon ignore the controversial bailout during an election year.

"We're not Pollyannaish," he says. "We're just trying to get prepared."

* * *

S&L Execs Feel Lack Of Clout, Survey Says

Despite the U.S. League's ambitious goals, nearly three of every four savings and loan directors say the industry lacks a voice in Washington powerful enough to achieve them.

Hamilton & Staff, a polling company in Washington, surveyed 134 S&L directors across the country for the **Concorde Group Ltd.,** an Alexandria, Va.-based management firm that specializes in turning around troubled thrifts.

"The savings and loan crisis, and the need for strong governmental intervention that followed, has obviously created a negative climate for the industry and its traditional trade representatives in Washington," the Hamilton & Staff report said.

Frederick Webber

"The current reassessment of policies and procedures toward the industry is contributing to these directors' feelings of powerlessness in Washington."

James H. Grohl, a spokesman for the U.S. League, said the survey "doesn't square with any information we have." League members have "demonstrated confidence in trade associations as a vehicle for communicating with Congress and other bodies in Washington."

League president **Frederick Webber** has been criticized by his predecessor, **William B. O'Connell**, for not battling hard enough on the industry's behalf. But after Mr. O'Connell leveled that charge in January, several thrift executives active in the association came to Mr. Webber's defense.

— **Phil Roosevelt**

* * *

New Group to Press For Insurance Powers

Insurance may be the most sought-after banking power of the 1990s. The **Financial Institutions Insurance Association**, a trade group dedicated to bringing the insurance and banking industries together, is forming a group to help state banking associations lobby their legislatures for greater access to insurance markets. The San Francisco-based group has about 85 members split between financial institutions and insurance-related companies, according to its president, **James M. Shelton**.

The **State Legislative Council** will hold its first meeting on April 23 in Chicago.

The council will act as a clearing house for information about various state efforts to get insurance powers, according to **Dick Starr**, the association's chairman and president and the chief executive of **UST Securities Inc.,** Los Angeles. The group will supply advocates with rebuttals to likely arguments by the state insurance lobby, he says.

Mr. Starr figures that more participants in a market mean more competition and lower prices for consumers. Lawmakers in Delaware, Florida, Illinois, Indiana, Maryland, Massachusetts, and Virginia are expected to vote on some sort of insurance legislation this year.□

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Profits Average, Not High, at Most Rescued Texas Thrifts

Continued from *page* **1**

siding over an insolvent insurance fund. To the outrage of Congress, he financed the transactions by issuing notes that became government obligations and rushed some deals to capitalize on tax breaks set to expire.

To attract investors, he relaxed capital guidelines, divvied up at least $1.8 billion of tax breaks, and left the government liable to pay acquirers up to $8.4 billion if earnings on distressed assets did meet prescribed levels.

Mr. Wall consistently underestimated the ultimate cost of the Southwest plan – pegged at $33 billion by the General Accounting Office – and was accused by Rep. Henry Gonzalez, chairman of the House Banking Committee, of offering deals so sweet that they could be likened to "golden mansions."

Hearings Set for April

Congress has ordered the Resolution Trust Corp. to audit the 15 rescues, along with 81 other deals completed by the Federal Home Loan Bank Board in 1988. And Mr. Gonzalez will conduct hearings on the Southwest plan in April.

Of the 15 transactions, two are providing rich returns for their owners, according to data compiled by Ferguson & Co. Blue Bonnet Savings Bank had an annualized return on equity of 72%. First Gibraltar Bank, bought by an investment group whose head is Ronald O. Perelman, posted a 60% return.

But eight thrifts had annualized returns in the range of 17% to 31%, which experts consider reasonable. Three thrifts reported returns of less than 3%. And two thrifts lost money.

'Where Is The Gold?'

"If the Southwest plan is a gold mine, where is the gold?" said George Barclay, president of the Federal Home Loan Bank of Dallas. "To the extent that earnings are not impressive, the government got a good deal."

More important, experts say, the rescues stopped the bleeding in Texas.

Together, the 79 insolvent thrifts involved in the transactions lost $3.6 billion in 1987 and $4.3 billion before their rescues in 1988. By contrast, the 15 merged survivors recorded $103 million of profits during the first nine months of 1989, Ferguson found.

Buyers have made progress in streamlining, stabilizing, and strengthening the 15 institutions.

The Best Possible Deals?

The 15 thrifts together shed $5.9 billion of risky assets during the nine-month period. They increased tangible capital by 30%, to $528 million. And they halved their use of costly brokered deposits.

"That's a lot better than doing nothing, even though the Southwest plan rescues obviously weren't the best possible deals," said Paul Horvitz, a professor of banking and finance at the University of Houston.

Some experts support the Southwest plan because it placed $47 billion of assets under the control of private owners, who can make decisions far more rapidly than can government bureaucracies. "The quicker the government places assets in the hands of private investors, the better," said Henry Peltz, a vice president at Keefe, Bruyette & Woods, New York, a consulting firm for the financial industry.

'The Returns Will Normalize'

Still, returns of the magnitude reported at First Gibraltar apparently will perpetuate the controversy surrounding the Southwest plan. "It's confirmation of the fact that Danny Wall gave away the candy store in 1988," said Bert Ely, the thrift consultant who for years has been an outspoken critic of the Bank Board.

First Gibraltar's chairman and chief executive, Gerald J. Ford, argues that the healthy returns guaranteed by federal assistance payments during the early years were designed to compensate investors for risks they took by investing in Southwest plan transactions.

"To defray the uncertainty, people will tend to build in cushions" of profitability, Mr. Ford said. "To the extent that the cushion was not needed, there might be, in the short term, some seemingly high returns. But over a three- to five-year period, the returns will normalize."

'Our Deal Got Changed'

Experts argue that hefty profits are the only inducement for investors to sink funds into the volatile thrift industry – especially when regulators and Congress appear willing, if not eager, to break contracts.

"It is not immoral that investors earn a big return when their capital is at risk," said one bank and thrift consultant, William Ferguson, principal of Ferguson & Co.

Some Southwest plan acquirers say they face even larger risks than they thought, because the government has subsequently eliminated some of the benefits in the transactions.

"Our deal got changed," said Matt Landry Jr., president and chief operating officer of AmWest Savings,Bryan, Tex. Because of a recent OTS decision to break Bank Board promises of low capital requirements, the investment required to sustain his $4 billion-asset thrift has tripled, meaning that each dollar of investment earns only a third of what it did before.

For that reason, Mr. Landry does not expect AmWest to sustain the 23% annualized return on equity posted during the first nine months of 1989.

A Scramble to Raise Capital

A similar situation exists at Dallas-based American Federal Bank. The thrift has abandoned growth plans and is scrambling to raise $50 million of additional capital by yearend.

William Gibson, the thrift's chairman, recently resigned. And Lone Star Technologies, the thrift's parent company, has been sued by shareholders who contend that they were misled about the potential profitability of its investment in American Federal.

Against this backdrop, experts say, it appears that most Southwest plan acquirers are getting too small of a return for the risks they incurred in doing business with the government.

The thrift law reduced the amount of assets that could be held with each dollar of invested capital, reducing investors' returns. And after government-subsidized assets are sold, Southwest plan owners will need to wring profits from institutions whose lending powers have been substantially restricted.

"Few Southwest plan investors would have done their deals if they had known of all of the regulatory changes," said Mr. Ferguson, whose firm negotiated several of the transactions.

Experts say the one big Southwest plan transaction that apparently has failed bears out the argument that healthy federal guarantees are necessary to attract capital and ensure a deal's success.

Prescription for Disaster

When it allowed ailing Southwest Savings Association to acquire four other insolvent Texas thrifts, the Bank Board extended assistance only on the assets Southwest acquired, not on its own distressed portfolio. Southwest, on the other hand, raised no additional capital in the takeover.

It was a prescription for disaster. Southwest lost $122 million during the 12 months that ended Sept. 30 and saw its tangible capital sink from a negative 1.65% to a negative 4.08%. The institution at Sept. 30 fell $329 million short of the tangible capital holdings required under the thrift reform law.

"It suggests that the deal wasn't sweet enough," said Mr. Horvitz. "The Bank Board should have provided more assistance and insisted on a substantial capital injection." □

How Thrifts Sold Under the Southwest Plan Are Faring

For the nine months ended Sept. 30, 1989. Dollars in millions

Thrift	Annualized return on average equity	Total assets	Return on average assets	GAAP capital
Blue Bonnet Savings Bank	71.69%	$3,338	1.03%	1.92%
First Gibraltar Bank	59.77	9,818	1.37	2.85
Heights of Texas	31.24	1,411	0.63	2.34
United Savings	29.16	3,583	0.74	3.15
Coastal Banc Savings	27.32	689	0.87	3.39
Americity Federal	25.75	515	0.71	2.65
AmWest Savings	23.23	3,988	0.33	2.00
American Federal Bank	18.76	3,050	0.42	2.02
Franklin Federal Bancorp	17.45	1,736	0.30	1.87
Merabank Texas	16.73	1,326	0.43	2.68
Pacific SW Savings Bank	3.31	1,125	0.07	2.11
Texas Trust Savings	2.15	664	0.09	4.03
First Heights	0.83	602	0.07	10.10
Southwest Savings	NA	5,934	-2.00	-3.64
Guaranty Federal	-2.71	4,043	-0.06	3.12
Aggregate	17.70	41,821	0.32	1.83

Note: Study excludes Sunbelt Savings, which still is owned by the federal government.

Source: Ferguson & Co.

Fortune's Debt, CDs Downgraded by S&P

Reuters

NEW YORK — Standard & Poor's Corp. said it downgraded about $24 million in subordinated debt of Fortune Financial Group Inc. to B-minus from B-plus.

It also cut the rating on certificates of deposit issued by a unit of the company, Fortune Savings Bank, to BB-minus/B from BB-plus/B.

S&P said the downgradings reflected declining trends in the company's profitability and asset quality. Partly mitigating these concerns, it said, are the Clearwater, Fla.-based thrift's strong retail franchise and adequate capitalization relative to its peers. □

CoreStates Deal Is Closed

PHILADELPHIA — CoreStates Financial Corp. announced the completion of its acquisition of First Pennsylvania Corp. CoreStates says it is now the largest banking organization in eastern Pennsylvania.

Terrence A. Larsen, chairman, said that over the next few months, the company will gradually concentrate its Philadelphia-based wholesale business in its Philadelphia National Bank and its retail business in First Pennsylvania. □

In Unusual Case, Troubled Sunbelt Seeks No Buyer

By STEVE KLINKERMAN

DALLAS — Call it a rescue in process. Or perhaps the rescue that never was.

In any case, call Dallas-based Sunbelt Savings a federally owned thrift that 20 months after its formation is not even seeking a buyer.

Technically, Sunbelt's is one of the 16 rescues completed under the Southwest plan, but it is the only one of the thrifts still operated by the government.

The $9.5 billion-asset company was formed in August 1988 through the merger of eight insolvent northern Texas thrifts. Lacking cash to pay off depositors, the Federal Home Loan Bank Board pledged $11.5 billion of assistance to the thrift and put Thomas Wageman in charge of welding the pieces together.

Though Mr. Wageman has made progress, Sunbelt remains the great oddity among the Bank Board's 1988 transactions. The institution has virtually no earnings or capital, funds less than half of its assets with deposits – and is not for sale.

"A number of things occurred that forestalled the completion of the transaction," said Mr. Wageman, who is president and chief executive of Sunbelt.

Rescue Operations Stopped

The Bank Board halted its rescue operations when thrift reform proposals was introduced in early 1989, Mr. Wageman said, and the completed law placed Sunbelt under the Federal Deposit Insurance Corp., which has not taken action on the company.

Industry sources speculate that Sunbelt will stay in limbo for quite a while. It is not clear whether the Bank Board's assistance guarantees to Sunbelt can be transferred intact to a buyer. And regulators hardly have time to negotiate a second Sunbelt rescue from scratch, given the 320 broke thrifts already under their control.

In that light, sources said, Sunbelt's apparent fate is to remain a federally subsidized asset disposition unit funded by advances from the Federal Home Loan Bank of Dallas and deposits. Mr. Wageman said Sunbelt sold $450 million of assets in 1989 and hopes to boost total sales to $1 billion in 1990.

Sources say the thrift got about $700 million of cash assistance from the government during the 12 months ended Sept. 30. □

NOTE

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